

STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
ERIC MOSKOWITZ	:	
	:	DETERMINATION
	:	DTA NO. 816252
for Redetermination of a Deficiency or for Refund of	:	
New York State and New York City Income Taxes under	:	
Article 22 of the Tax Law and the New York City	:	
Administrative Code for the Years 1992, 1993, and 1994.	:	

Petitioner, Eric Moskowitz, 2966 Cheryl Road, Merrick, New York 11566, filed a petition for redetermination of a deficiency or for refund of New York State and New York City personal income taxes under Article 22 of the Tax Law and the New York City Administrative Code for the years 1992, 1993, and 1994.

A hearing was held before Catherine M. Bennett, Administrative Law Judge, at the offices of the Division of Tax Appeals, 641 Lexington Avenue, New York, New York, on October 9, 1998, at 10:30 A.M., with all briefs to be submitted by May 31, 1999, which date began the six-month period for the issuance of this determination. Petitioner appeared by Lawrence F. Ruggiero, Esq. The Division of Taxation appeared by Terrence M. Boyle, Esq. (Kevin R. Law, Esq., of counsel).

ISSUES

I. Whether the Division of Taxation properly disallowed expense deductions which had been an integral part of Subchapter S losses reported by petitioner, and employee business expenses for tax years 1992, 1993 and 1994.

II. Whether petitioner has established grounds for abatement of penalties in this matter.

FINDINGS OF FACT

1. The Division of Taxation (“Division”) audited Eric Moskowitz’s (“petitioner”) New York State personal income tax returns for 1992, 1993 and 1994. The audit of petitioner’s return originated as a result of information obtained from a withholding tax audit of Sheil Medical Laboratory (“Sheil”), formerly known as Physicians Medical Laboratory Incorporated,¹ petitioner’s employer. As an employee of Sheil, petitioner had claimed an exemption from New York State tax withholding. In attempting to determine whether petitioner was qualified for such exemption, the auditor reviewed petitioner’s personal income tax filings for the tax years in issue, and became aware of large Federal Schedule E, Subchapter S corporation losses. The scope of the audit was to verify miscellaneous employee business expense deductions claimed on petitioner’s returns, and verify flow-through losses from Sure Marketing, Inc. (“Sure”), petitioner’s wholly-owned Subchapter S corporation.

2. Sure was incorporated in New York in 1990 and its New York State S Corporation Franchise Tax Return indicates that its principal business activity is sales. Prior to 1992, Sure was in the business of procuring blood samples from doctors upon which Sheil would perform blood analysis. At some time in 1992, Medicaid changed its rules with respect to whom Sheil

¹ Although petitioner’s W-2 indicates that he was paid by Physicians Medical Laboratory Inc., throughout the hearing the parties employed the name “Sheil,” which succeeded the former corporation and is hereafter used to refer to both corporations.

could pay to perform such services, and Sheil was required to discontinue payments to Sure as a corporation. Thereafter, Sheil hired petitioner as an employee to bring blood samples to the laboratory. The business of Sure shifted and took on a different purpose, which the Division had some difficulty defining. The Division believed that, in part, Sure was involved in transporting the blood samples. Additionally, there was some evidence of sales of surgical supplies by Sure to a company referred to as Sigma.

3. A significant portion of the funds upon which Sure was operating appeared to the Division to have as its source shareholder loans made from petitioner to Sure. During the years in issue petitioner was between the ages of 27 and 29, and he was paid a salary of between \$700,000.00 and slightly over \$1,000,000.00 for his work for Sheil. It appears from the record that petitioner's salary provided a significant portion of the shareholder loans made to Sure.

4. Petitioner, filed a New York State Resident Income Tax Return, Form IT-201, for tax years 1992, 1993 and 1994. Although it cannot be independently verified that the returns were timely filed, no late filing issue has been raised. The components of petitioner's personal income tax returns as relevant to this matter are discussed below.

Petitioner's return for 1992, in pertinent part, shows reported wages in the amount of \$710,191.00, a Schedule E Loss from Sure Marketing, Inc., a Subchapter S corporation, in the amount of \$295,194.00, New York adjusted gross income in the amount of \$414,604.00 and miscellaneous deductions from Federal Schedule A in the amount of \$153,078.00.² The following table shows a list of expenses, entitled "Employee Expenses" as attached to the 1992

² A list attached to the 1992 tax return reflects "Employee Expenses" in the amount of \$161,369.51. Although no explanation was provided as to why this amount differs from the Federal Schedule A deductions of \$153,078.00, it appears that the 2% floor adjustment imposed by the Internal Revenue Code ("IRC") factored into such reduction.

return and deducted as itemized deductions, in addition to those expenses which the Division disallowed on audit, and the explanation for such disallowance:

TABLE A

Expense Category	Schedule A Deduction	Disallowed on Audit	Explanation of Disallowance
Commissions	\$ 3,498.88		
Salaries	83,306.00	50,000.00	Salary to Mr. Lazar.
Accounting	825.00		
Automobile Expense	34,121.38		
Bank Charges	199.26		
Dues & Subscriptions	524.48		
Employee Benefits	3,560.75	3,560.00	No employees.
Insurance	3,688.90	3,179.00	4 cars, allowed one.
Legal	2,500.00		
Miscellaneous Expense	1,449.47		
Office Expense	174.53		
Office Supplies	10,252.36	10,252.00	Not verified.
Postage	49.00		
Repairs	1,719.18		
Supplies	3,120.77		
Taxes Payroll	518.00		
Telephone	3,989.09	2,992.00	Paid other peoples' bills.
Travel	5,267.60	2,634.00	Allowed 50%.
Utilities	2,604.86	2,604.00	Other peoples' charges.
Total	\$ 161,369.51	\$ 75,221.00	

Cost of Goods Sold (allowed on Schedule A; disallowed on 1120S) ³		(19,912.00)	
Net Deduction Disallowed		\$ 55,309.00	

A W-2 attached to the 1992 return shows wages paid to petitioner, at 3086 Driftwood Lane, Bellmore, New York, from Physicians Medical Laboratory (Employer ID Number 11-2618040), 608 Sheepshead Bay Road, Brooklyn, New York. Wages were reported as paid to petitioner in the amount of \$710,191.00, with Federal Taxes withheld in the amount of \$105,497.00. Although Social Security and Medicare taxes were withheld, no tax was withheld for New York State.

Petitioner's 1993 return reports wages paid by the same employer noted above in the amount of \$923,000.00, a Schedule E, Subchapter S loss generated by Sure Marketing, Inc. in the amount of \$442,974.00, New York adjusted gross income of \$479,963.00 and miscellaneous deductions from Federal Schedule A in the amount of \$126,391.00. The W-2 attached to petitioner's return indicates that Federal income tax in the amount of \$125,999.40 was withheld for 1993. Social Security and Medicare taxes were also withheld. However, there was no New York State withholding. Table B below sets forth the employee expenses deducted on petitioner's 1993 tax return, and the amounts disallowed by the Division.

³ The Division allowed \$19,912.00 of expenses for phlebotomy as an employee business expense on the basis that such expenses were connected to and incurred by petitioner with regard to his employment with Sheil. The expenses had been deducted as cost of goods sold on Sure's corporate tax returns (Form 1120S and CT-4S), but disallowed by the Division.

TABLE B

Expense Category	Schedule A Deduction	Disallowed on Audit	Explanation of Disallowance
Consulting Fees	\$ 100,000.00	\$ 100,000.00	Salary to Mr. Lazar.
Other Outside Services	29,315.00	0	
Local Travel	5,928.00	2,964.00	
Supplies	747.00		
Total	\$ 135,990.00	\$102,964.00	
Cost of goods sold: (allowed in Sch A from 1120S Direct Labor)		(10,612.00)	
Net Disallowed amount		\$92,352.00	

Petitioner's 1994 return reports wages paid by Physicians Medical Laboratory, Inc. in the amount of \$1,051,419.00, a Schedule E, Subchapter S loss from Sure Marketing, Inc. in the amount of \$561,167.00, New York adjusted gross income in the amount of \$491,653.00 and miscellaneous deductions from Federal Schedule A in the amount of \$133,281.00. The attached W-2 shows Federal income taxes (\$125,709.40), Social Security and Medicare taxes withheld; however, no New York State withholding is shown.

5. The Division's auditor was unable to determine with certainty what kind of business Sure was conducting. In an attempt to acquire substantiation for Sure's expenses in general for the three tax years, the auditor encountered the following:

a) Sure paid Herbert Lazar, petitioner's uncle, a consulting fee in the amount of \$450.00 per hour for consulting services which the Division categorized as "vaguely defined" and not substantiated by an employment or other type of agreement. The auditor noted in his report that Mr. Lazar received

“1099 income” from Sure in the amount of \$240,000.00 in 1992,⁴ \$300,000.00 in 1993 and \$334,000.00 for 1994. The Division discovered that Mr. Lazar had not filed returns for the years in question, and when the issue was raised, the Division was informed that he had not filed because he had a net operating loss carryforward, and owed no tax. Based on this information, the Division questioned further whether the payments to Mr. Lazar by petitioner were simply an attempt to shift income and not arms-length transactions.

b) Rent expense deducted by Sure was disallowed when no leases were provided. Further, the auditor’s visits to claimed rented locations could not be independently verified, since the premises were no longer rented. At a New York City address, the auditor was informed that petitioner or Sure never had an office in such location, but that a Dr. Pullano, whose office was located at 166 E. 88th Street, New York, New York, had dealings with Sheil through petitioner.

The Brooklyn address discussed during the audit was a planned site for a diagnostic center. However, the auditor found the address to be a large apartment complex in a less than desirable neighborhood, with no apparent public access for business purposes.

c) Substantiation was requested for all of Sure’s deductions. However, none was provided.

d) Sure’s former representative, Menachem David, CPA, produced Sure’s General Ledger (“G/L”). However, the auditor was unable to tie in the amounts listed on the G/L to other documents submitted. The records generally were not found to be in auditable form. Those source documents that were reviewed by the auditors were for personal expenses of petitioner and his family, such as meals for petitioner’s parents and uncle, and landscaping.

⁴ Although the Summary of Audit indicates this year to be 1993, it is believed to refer to 1992.

e) After February 1992, the only source of gross receipts identified by the Division for Sure was from Sigma in the amount of \$25,500.00 for sales of medical paper goods. However, the Division's examination of purchases did not show purchases of similar goods. There was no beginning or ending inventory of goods and no accounts payable.

6. The Division's auditor determined that there was no economic substance to the corporation and that it was merely being used to deduct personal expenses under the guise of being a legitimate business. It was on this basis that the Division disallowed all claimed expenses of Sure at the corporate level and the resulting Subchapter S losses for each tax year. Some of Sure's expenses, however, were allowed as unreimbursed employee business expenses, deductible on petitioner's personal tax returns. Some of these were verified expenses and others were expenses that the auditor determined would have been reasonable to incur even in the absence of substantiating documentation.

7. The Division issued a Notice of Deficiency dated March 25, 1996 asserting additional tax due for tax years 1992, 1993 and 1994 in the amount of \$140,848.42 plus penalty and interest, for a total of \$193,582.96. The tax assessed for each individual year was \$37,673.72 for 1992, \$48,257.23 for 1993 and \$54,917.47 for 1994.

8. Petitioner filed a Request for Conciliation Conference dated May 13, 1996. The request asserted the following facts:

The deficiency arose because of disallowed losses of Sure Marketing, Inc. (11-3006663), of which the taxpayer is 100% shareholder. The losses in question were incurred when the corporation ventured into businesses that were allied to its main business, namely marketing in the medical field. The new businesses realized gross income, but incurred net losses, in the quest for profit. There is no question that all expenses taken were paid. The expenses were ordinary and necessary, and deductible under Section 162 of the Internal Revenue Code.

A conciliation conference was conducted on June 20, 1997, and the statutory notices were recomputed to reflect a total tax deficiency in the amount of \$138,880.11, plus penalty and interest at

the applicable rate, by a Conciliation Order issued on November 21, 1997. Attached to the Conciliation Order were revised statements of personal income tax audit changes for 1992, 1993 and 1994 issued by the Division. The component adjustments and calculations for each of the years follow:

1992 Deficiency

Petitioner reported \$414,604.00 as his New York Adjusted Gross Income (“NY AGI”). To this amount, the Division added \$390,630.00 (comprised of the disallowed Federal Schedule E loss in the amount of \$295,194.00, plus the reported amount of gross receipts earned by Sure of \$95,436.00), to arrive at corrected NY AGI of \$805,234.00.

Petitioner claimed employment and miscellaneous expenses in the amount of \$161,370.00, prior to the 2% floor adjustment of Internal Revenue Code § 67(a), of which the Division disallowed \$75,221.00 (*see*, Table A, Finding of Fact “4”). However, since the Division allowed expenses in the amount of \$19,912.00 from Sure as an employee business expense on petitioner’s personal income tax return, the net disallowance resulted in \$55,309.00. The disallowance of \$55,309.00 was subtracted from the original claimed amount (\$161,370.00) to result in \$106,061.00. The amount was then limited by the 2% floor on the recomputed NY AGI of \$805,234.00 (or \$16,105.00), to arrive at \$89,956.00. Subtracting \$89,956.00 from the total reported employment and miscellaneous expenses on Federal Schedule A (\$153,078.00) resulted in disallowed expenses of \$63,122.00. This amount was subtracted from the itemized deductions originally reported of \$149,969.00 to arrive at \$86,847.00. This amount was adjusted pursuant to Tax Law § 615(f), leaving \$43,423.50 as the corrected itemized deduction. The corrected deduction was subtracted from NY AGI of \$805,234.00 to arrive at taxable income of \$761,810.50. Additional tax of \$37,797.44, plus penalties pursuant to Tax Law § 685(b) and (p), were computed.

1993 Deficiency

Petitioner reported \$479,963.00 as his NY AGI. To this amount, the Division added \$518,042.00 (comprised of the disallowed Federal Schedule E loss in the amount of \$442,974.00, plus the reported amount of gross receipts earned by Sure of \$75,068.00), to arrive at corrected NY AGI of \$998,005.00.

Petitioner claimed employment and miscellaneous expenses in the amount of \$135,990.00, prior to the 2% floor adjustment of Internal Revenue Code § 67(a), of which the Division disallowed \$102,964.00 (*see*, Table B, Finding of Fact “4”). However, since the Division allowed expenses in the amount of \$10,612.00 from Sure as an employee business expense on petitioner’s personal income tax return, the net disallowance resulted in \$92,352.00. The disallowance of \$92,352.00 was subtracted from the original claimed amount (\$135,990.00) to result in \$43,638.00. The amount was then limited by the 2% floor on the recomputed NY AGI of \$998,005.00 (\$16,105.00), to arrive at \$23,678.00. Subtracting \$23,678.00 from the total reported employment and miscellaneous expenses on Federal Schedule A (\$126,391.00) resulted in disallowed expenses of \$102,713.00. This amount was subtracted from the itemized deductions originally reported of \$142,309.00 to arrive at \$39,956.00. This amount was adjusted pursuant to Tax Law § 615(f), leaving \$19,798.00 as the corrected itemized deduction. The corrected deduction was subtracted from NY AGI of \$998,005.00 to arrive at taxable income of \$978,207.00. Additional tax of \$47,358.30, plus penalties pursuant to Tax Law § 685(b) and (p), were computed.

1994 Deficiency

Petitioner reported \$491,978.00 as his NY AGI. To this amount, the Division added \$650,226.00 (comprised of the disallowed Federal Schedule E loss in the amount of \$561,167.00, plus the reported amount of gross receipts earned by Sure of \$89,059.00), to arrive at corrected NY AGI of

\$1,142,204.00.

Petitioner claimed employment and miscellaneous expenses in the amount of \$85,765.00, prior to the 2% floor adjustment of Internal Revenue Code § 67(a), of which the Division disallowed \$50,500.00 (which is represented entirely by the disallowance of the amount claimed for professional supplies). The disallowance of \$50,500.00 was subtracted from the original claimed amount (\$85,765.00) to result in \$35,265.00. The amount was then limited by the 2% floor on the recomputed NY AGI of \$1,142,204.00, to arrive at \$22,844.00. Subtracting \$22,844.00 from the total reported employment and miscellaneous expenses on Federal Schedule A (\$85,765.00) resulted in disallowed expenses of \$63,511.00. This amount was subtracted from the itemized deductions originally reported of \$133,281.00 to arrive at \$69,770.00. This amount was adjusted pursuant to Tax Law § 615(f), leaving \$34,885.00 as the corrected itemized deduction. The corrected deduction was subtracted from NY AGI of \$1,142,204.00 to arrive a taxable income of \$1,107,319.00. Additional tax of \$53,724.37, plus penalties pursuant to Tax Law § 685(b) and (p), were computed.

9. A timely petition was filed on December 19, 1997 with the Division of Tax Appeals, challenging the disallowed deductions.

10. The only witness who testified on behalf of petitioner at the hearing was Mr. Lazar, petitioner's uncle. When questioned about his contribution to Sure, Mr. Lazar stated that he "gave advice," "assisted petitioner in getting ahead in the business world" and "introduced him to all the people that he knew to assist him in the successful operation of his venture." When asked to define the venture, Mr. Lazar indicated that it "originally started with the laboratory business." He was attempting "to assist him [petitioner], to show him when he was working with the laboratory business, there are many allied ventures that he could be involved in, Helm MRI, which is radiology, and the MRI, when the doctors order for it." He believed that he was "enlightening him [petitioner] to the

entire medical supply operation business. . . and . . .also enlightening him to the future with nursing homes, assisted living centers, adult homes” (Tr. pp.135-136).

During the audit Mr. Lazar submitted an affidavit which set forth in more detail than his testimony, his educational and business background. After graduating from New York University School of Business Administration in 1954, Mr. Lazar spent time as an insurance broker, a real estate broker, a business broker, the owner of a jewelry business, and owner-operator of a vision center. He was responsible for the formation of a medical plaza and suite of medical offices, a pharmacy, an ambulette service, and a surgical supply and rental corporation. During 1989-1990 Mr. Lazar became a consultant to petitioner to assist him with Sure. Subsequently he assisted petitioner with Helm Imaging Corp., described as a subsidiary of Sure, to create an MRI and Radiology Center on Avenue Z and East 12th Street, Brooklyn, New York. Mr. Lazar takes responsibility for the design and negotiation of petitioner’s contract with Picker Corp., for the purchase of the MRI equipment, and for the negotiations for the lease of the premises. Mr. Lazar further claimed that he assisted petitioner in the creation of Sands Mobile Corp to perform physical therapy and other work at various medical offices, and with the formation of MLM Trading Corp.

11. At the hearing, petitioner’s representative requested an opportunity to submit petitioner’s books and records for further review. Included in the evidence submitted to the Administrative Law Judge post-hearing were general ledgers for the periods ending 5/31/92, 6/30/92, 8/31/92, 11/30/92, 12/31/92, 4/30/93, 8/31/93, and 11/30/93. In each case with the exception of the General Ledger for the periods ended 6/30/92 and 12/31/92, attached to the G/L were general journal entries for the three months preceding and ending with the period defined by the G/L. In the other two cases, the general journal entries were only for the month defined by the G/L period.

Petitioner submitted checking account bank statements from EAB in the name of Sure Marketing Inc., 3086 Driftwood Lane, Bellmore, New York, for the 12 months of each tax year: 1992, 1993, and 1994.

Petitioner submitted two leases between M. Gardose-Pullano as landlord, and Sure Marketing, Inc. for the periods March 1, 1992 to December 31, 1992 and January 1, 1993 to December 31, 1993, for the lease of basement space and Apartment 3B at 166 East 88th Street, New York, New York. The amount of rent charged for the first 3 months of 1992 was \$600.00, and beginning June 1, 1992 until year end, the rent increased to \$3,133.33 per month. The amount of rent to be paid during 1993 was \$3,133.00 per month for the first six months of the year, and \$2,600.00 for the latter six months (which payments were substantiated by copies of canceled checks drawn on Sure's account). According to the document, the rented premises were to be used as a sales and business office for the company. The basement was for storage.

Petitioner submitted a quotation issued to Helm Medical Imaging, at the Brooklyn, New York address of 1021-1023 Avenue Z, by Picker International for a Computed Tomography Scanner. The quotation for the equipment, dated September 10, 1992, and was signed by petitioner on September 24, 1992, requested delivery on December 15, 1992, was in the amount of \$655,000.00. Attached to the quotation was a copy of a check #165 drawn on what appears to be a personal checking account of petitioner. Although difficult to discern, the date on the check appears to be September 24, 1992. The memo indicates that it was a 5% down payment on the Picker product (by reference to the quotation document number). The amount listed was \$21,960.00. A second copy of the same check shows that it was canceled by petitioner's bank. However, it was revealed at the hearing that ultimately petitioner was never able to take delivery of the machinery due to a problem with the leased space in which it was to be operated.

Finally, petitioner submitted pictures of a building with the name “Nathan Hale Court” over its archway. The pictures contained no identifying notations. Petitioner did not indicate the meaning of the submission.

12. The 12/31/92 General Ledger for Sure was submitted by petitioner post-hearing. Since this was the only year-end G/L submitted for the years under audit, it was reviewed in some detail. The document was dated February 11, 1993. The ledger entries were divided into six departments; however, there were postings noted only to Departments #1 and #2. No explanation was provided as to the purpose of the different departments or why only Department #2 entries were reported on the tax return. In attempting to trace the general ledger balances to the tax return’s balance sheet and income and expense items, certain significant discrepancies were noted:

Item	Amount Posted to Dept. #2 of the General Ledger	Total Amount Posted to the General Ledger	Amount per Tax Return
Shareholder L/P-A (Loans from shareholder)	N/A	\$579,201.30	\$306,915.00
Commission Income	\$27,597.40	115,569.40	95,436.80
Cash Expenses	15,750.00	342,939.28	0.00
Direct Labor	19,912.00	46,081.00	19,912.00
Salaries-Office	16,633.85	16,633.85	206,633.85
Travel	33,995.09	54,140.73	13,497.23
Supplies	18,359.01	19,684.01	31,783.28

In the case of other expenditures, the amounts posted to Department #2 (which differed from the total amounts posted to the General Ledger except for Advertising, Depreciation and Rent) could be traced to the tax return: Commissions, Accounting and Legal, Advertising, Depreciation, Dues and

Subscriptions, Employee Benefits, Insurance, Rent, Telephone and Utilities. There was no explanation provided as to why some items could be directly traced to the tax return, and why others differed so greatly.

A second General Ledger for the same period was submitted by petitioner, dated March 3, 1993. An attachment appears to have adjusting entries on a sheet entitled General Journal, dated February 11, 1993, which do not appear on the former GL. Both versions of the G/L and canceled checks revealed that during 1992 petitioner wrote checks payable to "Cash" over the course of the 1992 year which totaled approximately \$343,000.00. Petitioner endorsed and cashed the checks. In the G/L dated March 3, 1993, the cash withdrawn by checks from Sure totaling \$342,939.28 are reclassified: \$240,000.00 is charged to Salaries-Officers bearing a notation "Herb drew 1992," and \$102,939.28 is charged to Shareholders L/P with the notation "Eric drew 1992." Cash expenses were then eliminated in this version as an expense category. Although this appears to be a revised version of the 12/31/92 General Ledger, no clarification was provided as to why differing versions were submitted as evidence, or why, for example, appropriate charges to salaries were not entered into the books of record all throughout the year. Although the audit file refers to "1099 income" attributed to Mr. Lazar, there was no evidence of Form 1099 being provided by Sure to Mr. Lazar for any of the years in question.

A review of the checks submitted for tax year 1992 shows payments made to numerous individuals for "phlebotomy work." No explanation was provided at the hearing with regard to why Sure was making payment for such services and posting the same to the General Ledger account called "Direct Labor." The Division disallowed such expenses as a deduction to Sure, but believed there was some connection to Eric Moskowitz's employment by Sheil, and allowed the payments as an unreimbursed employee business expense. The amount allowed by the Division was \$19,912.00 for

tax year 1992. A similar adjustment was made in the amount of \$10,612.00 for tax year 1993.

Although the corresponding checks do not bear any notation and the record is unclear that the direct labor charge for 1993 also represents payments for phlebotomy services, it is likely that the Division made the same adjustment as 1992.

Checks written to Amoco, Exxon, Chrysler Credit and Nissan which were posted to the General Ledger account "Automobile Expenses" appear to have an obvious automobile expense connection. However, there was no explanation provided as to the nature of the payments, the connection to a particular vehicle, or the business purpose. There were additional postings to the Automobile Expense account that appear in the General Ledger to unidentified individual names, with no obvious connection to the business, and no explanation as to the nature of the expense and its connection to Sure. Furthermore, there is no documentation or other substantiation provided.

SUMMARY OF THE PARTIES' POSITIONS

13. Petitioner maintains that Sure Marketing operated with a profit motive, that the Division improperly disallowed the Subchapter S losses and unreimbursed employee expenses, that petitioner has shown all deductions are ordinary and necessary, and has properly substantiated the same.

14. The Division maintains that it properly disallowed expense deductions which were not ordinary and necessary business expenses or could not be verified by petitioner. The basis for disallowance of expenses at the corporate level was due to the fact that Sure lacked the requisite profit motive. Other deductions as an employee were disallowed due to lack of substantiation. The Division argues that petitioner has not established any basis for abatement of penalties, or carried his burden of proving that the Division's conclusions are erroneous.

CONCLUSIONS OF LAW

A. Petitioner carries the burden of proof to overcome the tax assessment in this proceeding, and

accordingly, it is incumbent upon him to prove the material facts which establish his entitlement to the business deductions of his wholly-owned Subchapter S corporation, the losses resulting therefrom, and the employee business deductions of his personal income tax return (Tax Law § 689[e]). Petitioner did not meet this burden with respect to any of the issues of this case.

B. The starting point for determining New York personal income tax liability is a taxpayer's Federal adjusted gross income ("AGI") (Tax Law § 612[a]; 20 NYCRR 112.1). Likewise, a taxpayer's New York itemized deductions are derived from the deductions taken from Federal adjusted gross income (Tax Law § 615[a]; 20 NYCRR 115.1), with modifications not in issue herein. Since the New York State personal income tax is patterned after the Federal income tax laws, the Internal Revenue Code ("IRC") provides guidance with respect to the deductibility of the various expenses.

An S corporation's income and losses are passed through to its shareholders and taken into account by them in determining their individual tax liability (Merten, Law of Federal Income Tax § 41B:169). Such was the case here, where significant S corporation losses were factored into petitioner's Federal AGI, raising questions at the audit level. The losses resulted from alleged business deductions which far exceeded the income received and reported by Sure, petitioner's S corporation. The primary issues examined by the Division were whether this corporation was actually carrying on a "trade or business," and, if so, whether the business deductions were ordinary, necessary and substantiated.

Neither the Internal Revenue Code nor the regulations provide a definition of what is meant by a "trade or business." However, the phrase generally refers to an activity carried on for a livelihood, or for profit. A profit motive must be present, and some type of economic activity must be conducted (2 Stand Fed Tax Rep [CCH] ¶ 8471.1075).

Deductions are a matter of legislative grace and a taxpayer must be able to show that the

deduction sought comes within the express provisions of the statute (*see, New Colonial Ice. Co. V. Helvering*, 292 US 435, 440). IRC § 162(a) allows a taxpayer to deduct all ordinary and necessary business expenses paid or incurred during the taxable year in carrying on any trade or business, including, for example, a reasonable allowance for salaries or other compensation for personal services actually rendered (IRC § 162[a][1]). An ordinary expense is one that is common and acceptable in the particular business. A necessary expense is an expense that is appropriate and helpful in carrying on a trade or business (*Jones v. Commissioner of Internal Revenue*, 76 TCM 1014). Business expenses include those incurred by an employee, and may qualify as unreimbursed employee expenses, deductible as miscellaneous itemized deductions, subject to two percent of the employee's AGI. No deduction is allowed for personal, living or family expenses (IRC § 262).

Regarding proof of deductions, the Tax Court, in *Marian Wilson v. Commissioner* (77 TCM 1923) held:

A taxpayer must substantiate any deductions claimed and bear the burden of substantiation. Taxpayers are required to maintain adequate records sufficient to enable the Commissioner [of Internal Revenue] to determine the taxpayer's correct tax liability. Generally, if a claimed business expense is deductible, but the taxpayer is unable to substantiate it, the Court is permitted to make as close an approximation as it can [citing *Cohan v. Commissioner*, 39 F2d 540]. That estimate, however, must have a reasonable evidentiary basis.

In addition to the requirements of § 162, § 274(d) requires strict substantiation of certain expenses including those incurred with respect to any listed property as defined in § 280F(d)(4), which includes any passenger automobile. A taxpayer is required to substantiate expenses for listed property by establishing the amount, time, place, and business purpose of the expense (*see*, § 274[d]). This section supersedes the doctrine in *Cohan v. Commissioner, supra*. (*see*, § 1.274-5T[a][4]).

C. The first issue to be addressed is the question of whether Sure was operating as a trade or business. When Sure was incorporated in 1990, it appears to have had a valid purpose, i.e., as a company which procured and transported blood samples from various doctors and medical practices

for analysis by Sheil Medical Laboratory. However, when the Medicaid rules were changed regarding payments to corporations for such services, petitioner, Sure's sole owner, became an employee of Sheil to perform the same tasks. This significant change in circumstance essentially left Sure without the purpose for which it was originally formed. Perhaps this explains why the Division was unclear about the business purpose of Sure for the years in issue. The only testimony provided on this issue was by Herbert Lazar, petitioner's uncle, who consulted with and was highly compensated by Sure. As established by the record, Mr. Lazar's business background was quite varied (*see*, Finding of Fact "9"). Although there is no evidence that Mr. Lazar's business endeavors were successful ones, he certainly became business savvy with such experiences, and it was advice based upon these experiences that he provided to Sure in his consulting capacity. All that said, Mr. Lazar was unable to indicate clearly the function of Sure during the years in issue. He spoke of allied ventures, introducing Eric to other business executives and helping petitioner get ahead in the business world. His testimony confused petitioner's performance for Sheil with functions for Sure, brought into the discussion other corporations that petitioner made some attempt at getting started, and he continually responded in an evasive manner. Eric Moskowitz did not testify on his own behalf; nor did he submit an affidavit to establish facts in his absence. Petitioner's representative argued that certainly the time and effort put forth by Eric establishes that he intended for *Sure* to make a profit. He alleges that Eric worked 7 days a week, 20 hours a day, devoting 100% of his time and efforts to ensure that Sure would be successful. When the Administrative Law Judge questioned what Eric, as a 27-year old man, did to earn \$710,000.00 (referencing the 1992 W-2 from Sheil), Mr. Lazar indicated that Eric worked 7 days a week, 20 hours a day, providing marketing and other services for the doctors [for *Sheil*]. Obviously petitioner could not be devoting an equal amount of time and energy in such high volume to both businesses and he was being paid extraordinary salary amounts by Sheil to perform. Justifiably, the

Division found questionable whether the motives to insure the success of Sure were real.

The Division further considered the general ledgers, general journal entries, bank statements, canceled checks and other evidence produced by petitioner. The records were incomplete and could not be traced in large part to the corporate tax returns. The checks were without explanations that connected such expenditures to a business function of Sure, and the deductions unsubstantiated by any additional source documentation. Many expenditures appeared personal in nature, and no explanation to the contrary was offered by petitioner. The only testimony provided to support income and expenditures of Sure, Mr. Lazar's, was often unresponsive, vague and without any independent substantiation. Such testimony, with nothing more, is deemed unreliable.

In arriving at its determination to disallow petitioner's Subchapter S loss, the Division viewed all the facts surrounding the corporate existence. The Division determined there was no economic substance to Sure, and it was merely a vehicle used to deduct personal expenses under the guise of being a legitimate business. The Division's determination as to the losses is a valid one. Since it appeared to the Division, however, that some of the expenses claimed by Sure may have actually been incurred by Eric in his role as an employee of Sure, the Division permitted the deduction of such expenses as unreimbursed employee expenses.

D. Assuming *arguendo* that Sure operated as a "trade or business," the same result would ensue. Petitioner provided scant information regarding Sure's corporate deductions, mostly in the form of canceled checks. Unfortunately, they were not categorized or otherwise explained. Having received checks for 36 months into evidence after the hearing, without the benefit of any explanation or testimony, one would have to make great leaps to connect most of the checks to any business activity of Sure. Even if such connection could be made or inferred, there was no submission of source documentation to substantiate the expenses. The documentation reviewed during the audit showed a

significant amount of personal expenses being paid through Sure. The documentation reviewed post-hearing by the Administrative Law Judge contained discrepancies when amounts were posted to the G/L and traced to the tax return; cash drawn out of the company in large sums went to Mr. Lazar and petitioner, according to Sure's records; no explanation was provided to adequately connect many of the expenses to any business activity, despite the fact that some may have been legitimate business deductions. However, in that light, the Division permitted some deductions to be taken on petitioner's personal tax return. Though perhaps generous under the circumstances, I affirm the Division's decision to make such modification (*Cohan v. Commissioner, supra*).

E. Petitioner alternatively argued that the deductions should be allowed as start-up costs, which are governed specifically by IRC § 195. It has been held that expenditures incurred in the course of a general search for, or investigation of, an active trade or business in order to determine whether to enter a new business and which new business to enter (other than costs incurred to acquire capital assets that are used in the search or investigation) qualify as investigatory costs that are eligible for amortization as start-up expenditures under IRC § 195 (Rev Rul 99-23). IRC § 195 essentially provides that if the definition of "start-up expenditure" is met, the deduction is amortized over a 60-month period *beginning with the month in which the active trade or business begins*. In the case of Sure, since the commencement of an active trade or business was virtually unable to be determined, the amortization provision of IRC § 195 was not available to petitioner.

F. Penalties were imposed by the Division pursuant to Tax Law § 685(b), where the deficiency arises due to negligence or intentional disregard of Article 22 of the Tax Law, and Tax Law § 685(p), for the substantial understatement of the income tax liability for each of the tax years in issue. The penalties imposed under Tax Law § 685(p) may be waived, in full or in part, if there was reasonable cause for the understatement and the taxpayer acted in good faith. Petitioner did not allege the

impropriety of such penalties, nor introduce any evidence to support their abatement. Thus, the penalties are deemed proper.

G. The petition of Eric Moskowitz is denied, and the notice of deficiency dated March 25, 1996 for tax years 1992, 1993 and 1994 is hereby upheld.

DATED: Troy, New York
November 24, 1999

/s/ Catherine M. Bennett
ADMINISTRATIVE LAW JUDGE